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**Supreme Court of the United States**

**OCTOBER TERM, 1944**

**No. 436**

**BOLIVIAN INTERNATIONAL MINING CORPORATION,**

*Petitioner,*

*v.*

**COMMISSIONER OF INTERNAL REVENUE,**

*Respondent.*

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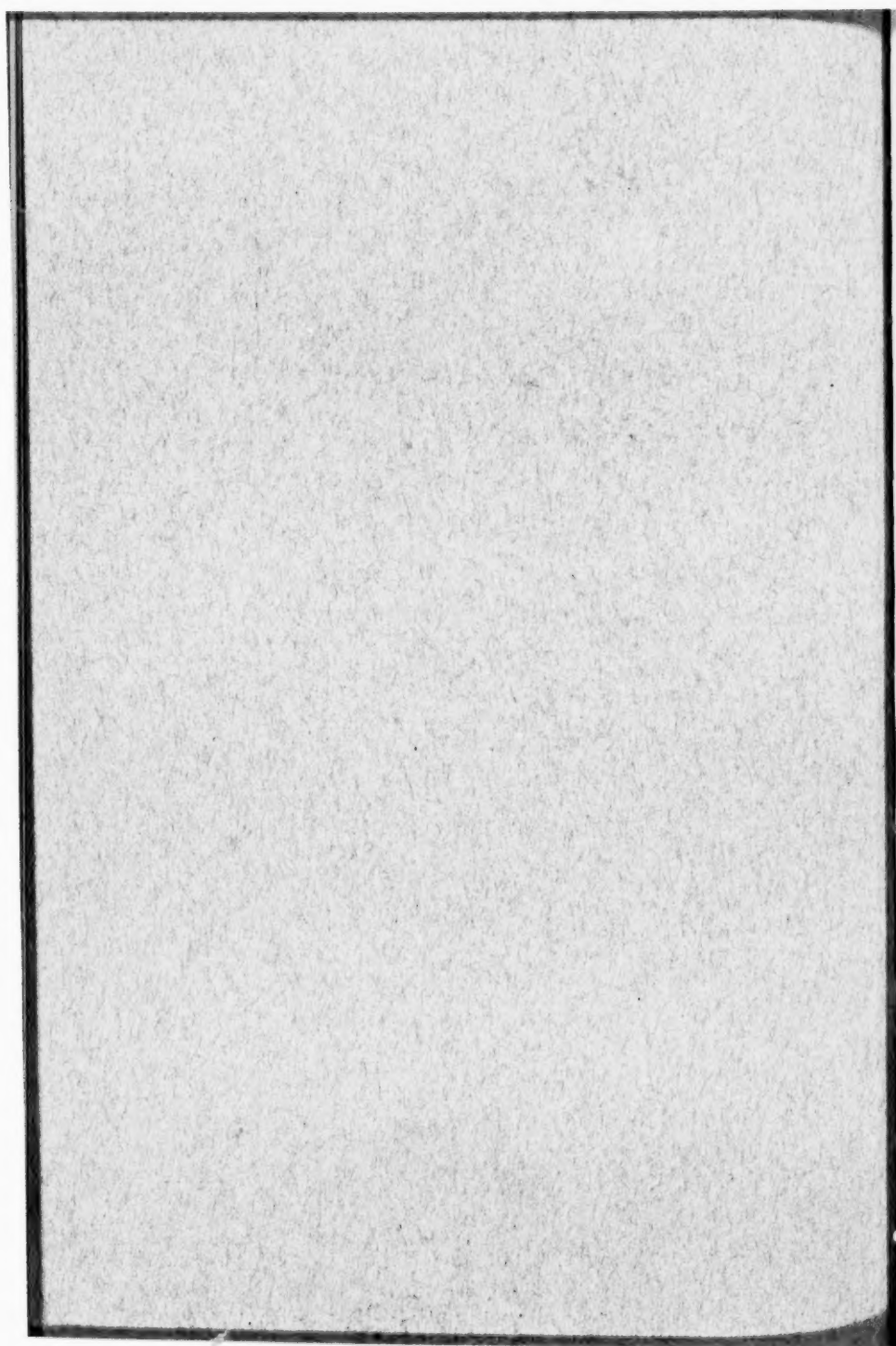
**PETITION FOR WRIT OF CERTIORARI TO THE  
UNITED STATES CIRCUIT COURT OF APPEALS  
SECOND CIRCUIT AND BRIEF THEREON**

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**HUBERT E. ROGERS,  
JOHN F. CONDON, JR.,**  
*Solicitors for Petitioner.*

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*v.*

COMMISSIONER OF INTERNAL REVENUE,  
*Respondent.*

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## **PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS, SECOND CIRCUIT**

TO THE HONORABLE THE CHIEF JUSTICE AND THE ASSOCIATE  
JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

The petition of BOLIVIAN INTERNATIONAL MINING CORPORATION respectfully shows to this Honorable Court:

### **Summary and Statement of the Matter Involved**

Petitioner, Bolivian International Mining Corporation, prays that a writ of certiorari issue to review the determination of the United States Circuit Court of Appeals for the Second Circuit, entered the 22nd day of May, 1944, affirming a decree of the Tax Court of the United States. The order for mandate of the Circuit Court of Appeals was filed June 7, 1944. A certified transcript of the record of the case, including the proceedings in said Circuit Court of Appeals, is furnished herewith in compliance with the rules of this Court.

Petitioner instituted a proceeding against the Commissioner of Internal Revenue in the Tax Court of the United States for a redetermination of a surtax assessed by the Commissioner on alleged undistributed profits for the year 1936 in the amount of \$10,378.34, and for 1937 in the amount of \$2,558.42.

Petitioner claimed a credit for the taxable years 1936 and 1937 in computing its tax under Section 14 of the Revenue Act of 1936 entitled "Surtax on Undistributed Profits" under Section 26(e) of the Revenue Act of 1936, on account of a written contract executed by the corporation prior to May 1, 1936 restricting the payment of dividends. The Commissioner disallowed these claimed credits and asserted deficiencies in each of said years.

Subsequent to Commissioner's determination and to the filing of the petition before the Board of Tax Appeals, but prior to trial, the Revenue Act of 1942 was enacted. Section 501 of the Revenue Act of 1942 amended Section 26 of the Revenue Act of 1936 by adding thereto a subdivision (f), entitled "Deficit Credit", making available to certain taxpayers an additional credit against surtax on undistributed profits imposed by Section 14 of the Revenue Act of 1936. The 1942 amendment of Section 26 of the Revenue Act of 1936 was made retroactive to the date of the enactment of the Revenue Act of 1936, and taxpayers affected thereby were given one year within which to file claims for refund or credit.

Prior to the trial before the Tax Court petitioner claimed a credit with respect to the year 1936 under the provisions of said Section 26(f). Respondent disallowed such credit. Petitioner then was granted leave by the Tax Court of the United States to amend its petition so as to include therein a claim for credit under Section 26(f) of the Revenue Act of 1936, as amended by the Revenue Act of 1942.

The Tax Court of the United States found against your petitioner and in favor of the Commissioner on May 18, 1943, which decision is reported in 1 T. C. 1110, the findings

of fact and opinion being included in the record (R. 303-324). Your petitioner appealed to the United States Circuit Court of Appeals from the decision entered under said opinion. The Circuit Court of Appeals affirmed the decision of the Tax Court. The decision was entered without opinion on May 22, 1944 and is reported in 142 F. (2d) 556 and is included in the certified transcript of the record at page 136.

Petitioner is a Delaware corporation resulting from the statutory merger of two Delaware corporations effected in December, 1935. The Delaware corporations were petitioner, Bolivian International Mining Corporation (hereinafter sometimes referred to as "BIMC"), the continuing corporation, and Boltin, Inc. (hereinafter sometimes referred to as "Boltin" (fols. 103-141).

The status of the corporations involved in the statutory merger prior to the merger in December, 1935 was as follows:

Boltin was a Delaware corporation with shares issued as follows:

Irving W. Bonbright.....	354
O. B. Perry.....	354
George A. Easley.....	185.8
A. G. Dibbs, as nominee for Hubert E. Rogers.....	106.2
Total.....	<u>1,000.0</u>

BIMC, petitioner herein, prior to the merger in December, 1935, was a Delaware corporation, all the stock of which was held by Boltin, Inc.

In 1935, prior to the merger, Boltin was indebted to three of its four stockholders in the aggregate amount of \$1,002,938, represented by notes as follows:

Bonbright .....	\$454,162.92
Perry .....	454,162.92
Easley .....	94,612.16
	(fols. 305, 306)

Rogers, one of the stockholders, never owned any notes of Boltin, and, because of the conflict of interest between Rogers on one side and Bonbright, Perry and Easley on the other, the renegotiations of the Plan of Merger of BIMC and Boltin were deadlocked during 1934 and the latter part of 1935.

The controversy between Rogers on the one side and Bonbright, Perry and Easley on the other arose when Rogers objected to any merger plan which would require the paying off of the note indebtedness owing to Bonbright, Perry and Easley before the payment of any dividends to stockholders (fol. 307). After negotiations of more than a year, the differences between the parties were reconciled and accord on the Plan was reached in October, 1935 (fols. 308-309), as follows:

On October 14, 1935, Bonbright in Rogers' presence wrote to Perry in San Francisco as follows (fols. 308-311; Exhibit S-A, set forth in full fols. 94-101):

"My dear Perry:

This morning I am in receipt of your letter of the 10th October; also, of a letter from Rogers in which he accepts, without qualification, the proposed compromise conditions named in my letter to him of the 11th October, a copy of which was sent to you by air mail on that day, together with the original of his letter to me of the 10th October.

\* \* \* \* \*

Under the plan as now agreed to, subject to your approval, funds of the Company as made available through the setting aside of depletion reserve, etc., to the extent of \$150,000. per year, will be used toward retirement of the new notes: interest at the rate of  $3\frac{1}{2}$  percent. per annum on said notes will then be paid, and, if additional funds are available, twelve cents per share per annum will be declared in dividends on the approximately 160,000 shares of B. I. M. C. stock. Any funds available in any year, after provision of the items named above, to go toward the further retirement of the notes.

You are correct in your assumption as to what I meant in my letter to Mr. Rogers about 'elimination of any stock not required for immediate purposes of the merger.' There will be no stock beyond what is required to satisfy the proposed deliveries to Boltin shareholders and the amount required to be held in the treasury for possible conversion of notes.

Before this letter reaches you, you will doubtless have received the correspondence above referred to, namely, Mr. Rogers' letter of October 10th, and copy of my reply of October 11th. And I hope after reading those letters and this one, you will have a clear picture in your mind.

To make sure that all of our minds have met with regard to the points I have covered in this letter, I am sending a copy to Mr. Rogers, and one to Mr. Armitage and if you do not hear to the contrary by wire, you will know that all here are in agreement. And, in that case, I will be glad to have you wire your approval in order that Mr. Armitage may proceed without further delay, in the preparation of the final papers.

With kindest regards,

Yours very truly,

IRVING W. BONBRIGHT."

In response to the letter of October 14, 1935, Perry wired Bonbright on October 16, 1935, as follows:

"YOUR LETTER OCTOBER FOURTEENTH REGARDING BOLTIN BIMCO MERGER STOP I APPROVE PLAN TO WHICH YOUR LETTER REFERS"

The only other person interested in the Plan of Merger was Mr. Easley, a noteholder and stockholder who personally attended a great many of these discussions and conferences (fol. 346) and who ultimately was one of the signers of Agreement of Merger and Consolidation, Petitioner's Exhibit S-C (fol. 126).

In other words, upon receipt of the telegram of approval from Perry, Bonbright, Easley and Rogers, the holders of all of the stock of Boltin, and Bonbright, Perry and Easley, the holders of all of the note indebtedness of

Boltin, had agreed on the Plan of Merger of BIMC and Boltin. The merger had been held up for more than a year because of the refusal of Rogers to a restriction prohibiting the payment of any dividends by the continuing corporation, BIMC, petitioner herein, until the note indebtedness owing to Bonbright, Perry and Easley had been liquidated.

The Plan as set forth in the letter from Bonbright to Perry of October 14, 1935 (fols. 308-311) provided in brief as follows:

(1) \$150,000 per year was to be set aside out of depletion reserve to be used toward the retirement of the new notes.

(2) Interest at the rate of 3% per annum on the said notes was then required to be paid.

(3) If additional funds were available, 12¢ per share per annum was to be declared in dividends on the BIMC stock.

(4) Any funds available in any year after provision for the items named above were to go toward the further retirement of the notes.

This agreement was entered into at arms' length, after negotiations extending more than a year between the four persons concerned, who were in complete control of petitioner and Boltin. Bonbright, Perry, Easley and Rogers, through stock ownership, controlled Boltin, which owned all the stock of BIMC. Bonbright, Perry and Easley held all the outstanding note indebtedness of Boltin, which indebtedness was to be assumed by BIMC in the merger.

Pursuant to resolutions and corporate action, the Agreement of Merger, Exhibit S-C (fols. 103-141), was executed and filed in the State of Delaware. It is interesting to note that in various capacities Messrs. Bonbright, Perry, Easley and Rogers signed the Merger Agreement, and that the Merger Agreement provided that Bonbright, Rogers, Easley and Perry were to be directors of the merged corporation (fol. 113), and that Bonbright was to be president.



There are two paragraphs of the Merger Agreement (fol. 114) of particular significance: paragraph Sixth, which provides that all franchises, rights, privileges, powers and property of Boltin shall be merged and vested in BIMC, the continuing corporation, and paragraph Seventh, which states that

"All rights of creditors and all liens upon the property of either of said corporations shall be preserved unimpaired, and all debts, liabilities and duties of Boltin, Inc., shall thenceforward attach to said Bolivian International Mining Corporation, the continuing corporation, and may be enforced against it to the same extent as if the said debts, liabilities and duties had been incurred or contracted by it."

The first time after the merger that the question of paying a dividend arose was at the directors' meeting on August 4, 1936, at which meeting (fol. 315) the following resolution was adopted:

"RESOLVED: That in accordance with the terms of the agreement of merger and consolidation of Boltin, Inc. and Bolivian International Mining Corporation, the escrow agreement dated the 10th day of March, 1936, and the stockholders' agreement of October 14, 1935, that a dividend of 12¢ per share be paid on this Corporation's outstanding shares of stock \* \* \* and that the officers of the Corporation be and they hereby are directed to pay such dividend on the 21st day of August, 1936 to the registered holders of the shares of the Corporation as of the 19th day of August 1936."

Dividends of 12¢ per share for 1936 aggregated \$19,-224.72. Dividends of 12¢ per share were declared in the year 1937, aggregating \$22,860 (fol. 88). Whenever dividends have been declared since the year 1937 the dividends in any one year have been 12¢ per share.

During the year 1936 petitioner redeemed outstanding notes in the amount of \$103,838, and during the year 1937 petitioner redeemed outstanding notes of \$299,100 (fol. 316).

On January 1, 1936, taxpayer had a deficit in earnings and profits of \$55,305.77 (fol. 92). For the year 1936 taxpayer's adjusted net income was \$75,946.41. In 1936 earnings and profits as adjusted in respondent's deficiency notice amounted to \$87,984.01 (fol. 317).

In its income tax return for the year 1936 petitioner claimed a credit in the amount of \$41,223.30 under Section 26(c) of the Revenue Act of 1936.

### **Jurisdiction**

The jurisdiction of this Court to issue the writ of certiorari applied for rests upon Title 28 of the United States Code Annotated, Section 347.

### **Questions Involved**

FIRST: For the years 1936 and 1937, in computing the tax imposed by Section 14 of the Revenue Act of 1936 (Undistributed Profits Tax), is petitioner entitled to a credit under Section 26(c) (1) of that Act, on account of a written contract executed prior to May 1, 1936, restricting the payment of dividends?

SECOND: For the years 1936 and 1937, in computing the tax imposed by Section 14 of the Revenue Act of 1936 (Undistributed Profits Tax), is petitioner entitled to a deficit credit under Section 26(f) of that Act as amended by Section 501 of the Revenue Act of 1942 equal to the amount by which the adjusted net income exceeds the sum of

(1) Earnings and profits accumulated after February 28, 1913, as of the beginning of the taxable year; and

(2) Earnings and profits for the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year)?

### Reasons Relied On for Allowance of the Writ

(1) The Circuit Court of Appeals erred in affirming the finding of the Tax Court of the United States that for the years 1936 and 1937 petitioner was not entitled to a credit under Section 26(c)(1) of the Revenue Act of 1936 on account of a written contract restricting the payment of dividends.

(2) The Circuit Court of Appeals erred in affirming the decision of the Tax Court of the United States construing Section 26(f) of the Revenue Act of 1936 as amended to the effect that deficit credit within the meaning of that statute cannot mean any amount less than zero and "deals only with positive earnings and profits" (fol. 322).

(3) The Circuit Court of Appeals erred in affirming the decision of the Tax Court of the United States to the effect that petitioner was not entitled to a credit under Section 26(f) of the Revenue Act of 1936 as amended, even though the Commissioner of Internal Revenue stipulated that petitioner had a deficit (fol. 92).

(4) The questions herein involved are of general importance to all taxpayers and present questions relating to the substance of tax statutes of the United States.

(5) The decision of the Circuit Court of Appeals is in conflict with the decisions of the Circuit Court of Appeals for the Sixth Circuit in *Automotive Parts Company v. Commissioner*, 134 F. (2d) 420, and the decision in the Second Circuit in *van Ameringen-Haebler, Inc. v. Commissioner*, 132 F. (2d) 855.

(6) The decision of the Circuit Court of Appeals appears to have been predicated largely upon the decisions of the Supreme Court of the United States in *Dobson v. Commissioner*, 320 U. S. 489, 64 SCT 239, 247, 88 L. Ed. 179,

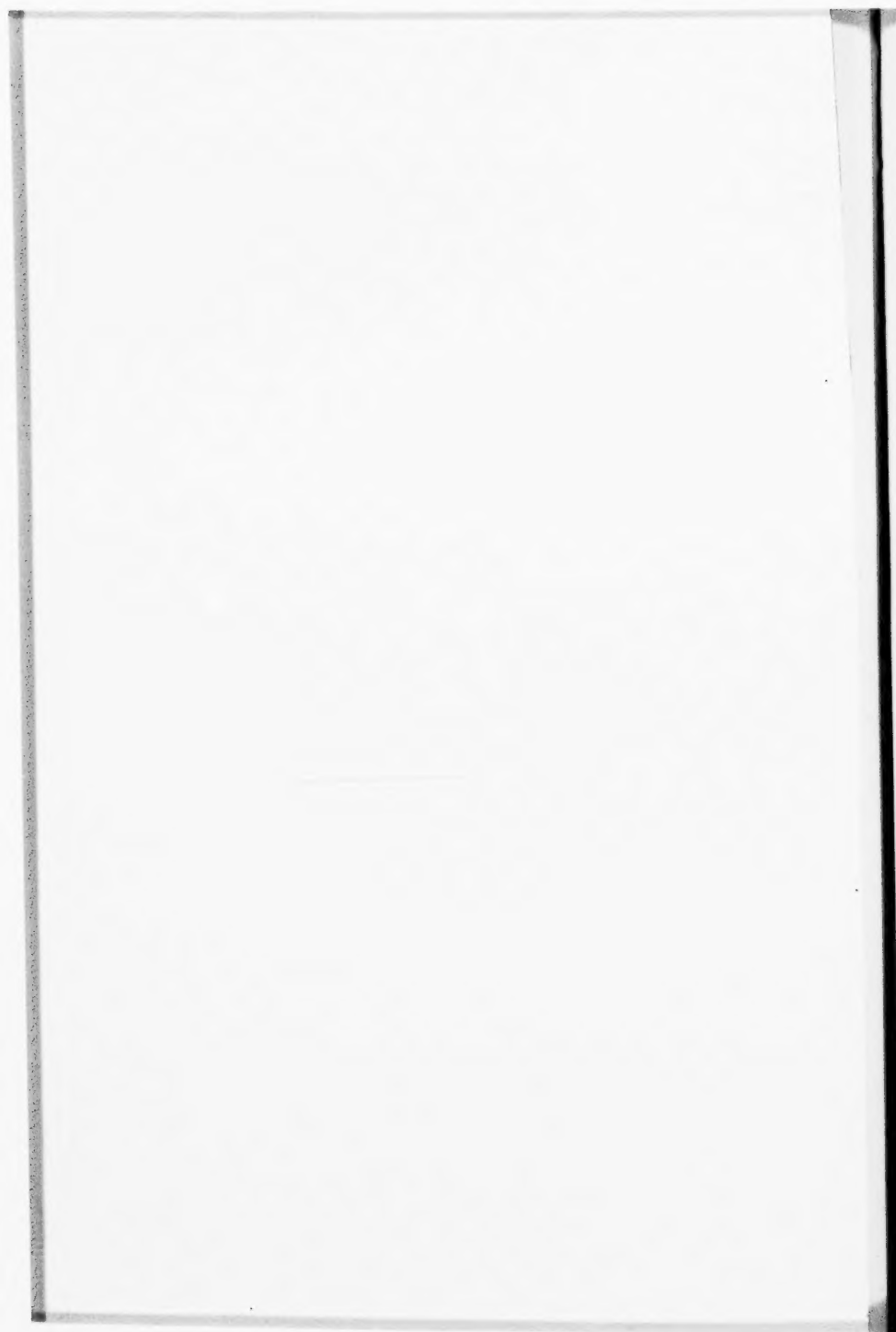
and *Commissioner v. Heininger*, 320 U. S. 467, 64 SCT 249, 254, 88 L. Ed. 197, to the general effect that the Circuit Court of Appeals should not review a decision of the Tax Court of the United States on a question of fact; the construction by the United States Circuit Court of Appeals of the effect of said decisions deprives petitioner of a review of a decision on a question of law by the Tax Court of the United States to which it is justly entitled.

(7) The decision of the Circuit Court of Appeals affirming a decision of the Tax Court and the determination of the Commissioner in asserting a tax against petitioner because of failure to distribute income during the years 1936 and 1937 is erroneous and is unconstitutional because the asserted tax is not an income tax, but a tax upon capital, and as such has not been apportioned among the several states as required by Article I, Section 2, of the Constitution, which requires that all direct taxes shall be apportioned according to population.

WHEREFORE, your petitioner prays the allowance of a writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit in this case, there entitled, *Bolivian International Mining Corporation, Petitioner, v. Commissioner of Internal Revenue, Respondent*, No. 218, October Term 1943, that said cause may be reviewed and determined by this court, and that the judgment of the said Circuit Court of Appeals may be reversed and set aside; and for such further relief and remedy in the premises as to this court may seem meet and proper.

BOLIVIAN INTERNATIONAL MINING CORPORATION,  
HUBERT E. ROGERS,  
JOHN F. CONDON, JR.,  
Solicitors for Petitioner.





# Supreme Court of the United States

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BOLIVIAN INTERNATIONAL MINING CORPORATION,  
*Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE,  
*Respondent.*

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## BRIEF IN SUPPORT OF PETITION

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### Opinions Below

The findings of fact and opinion of the Tax Court of the United States are found at folio 302 of the record, and are reported in 1 T. C. 1110. The United States Circuit Court of Appeals, Second Circuit, affirmed the Tax Court without opinion see folio 408 and is reported in 142 Fed. (2d) 556.

### Jurisdiction

The jurisdiction of this Court to issue the writ of certiorari applied for is predicated upon Title 28 of the United States Code Annotated Section 347.

The reasons relied on for the allowance of the writ are that the United States Circuit Court of Appeals for the Second Circuit decided questions of general importance and questions of substance relating to the construction

of a statute of the United States, namely, a tax law pertaining to credits granted corporations as a deduction in determining the Undistributed Profits tax liability of corporations and particularly the relief provision Section 26(f) entitled "Deficit Credit" of the Revenue Act of 1936 as amended which questions have not been, but should be settled by this Court.

### **Statement of the Case**

The statement of the case is set forth in the petition for writ herein.

### **Specifications of Error**

The United States Circuit Court of Appeals for the Second Circuit erred in deciding:

FIRST: That the Tax Court of the United States correctly decided that petitioner was not entitled to a deduction from the tax imposed by Section 14 of the Revenue Act of 1936 of petitioner's admitted deficit under the "Deficit Credit" Section 26(f) of the Revenue Act of 1936 as amended by the Revenue Act of 1942.

SECOND: That the Tax Court's interpretation of Section 26(f) entitled "Deficit Credit" to the effect that "It deals only with positive earnings and profits. It does not contemplate a minus or red figure in lieu of accumulated earnings. This language must dominate the section, rather than a colloquial meaning of the heading 'Deficit Credit'" (fol. 322), as stated in the opinion, was correct.

THIRD: That the Tax Court's decision that petitioner did not execute a written contract prior to May 1, 1936, which expressly restricted the payment of dividends was correct.



FOURTH: That the Circuit Court of Appeals was apparently limited in its review by the directions contained in the *Dobson* and *Heininger* decisions of this Court.

FIFTH: That petitioner had a deficiency in income tax of \$10,378.34 for 1936 and of \$2,558.42 for 1937.

### **Statutes and Regulations Involved**

The Revenue Act governing income tax liability for the years 1936 and 1937 is the Revenue Act of 1936. The statutory provisions directly involved in this proceeding are Sections 14(a) and (b) and 26(e) of the Revenue Act of 1936, which provide as follows:

"Section 14 (Revenue Act of 1936 as amended).

(a) DEFINITIONS—As used in this title—

(1) The term 'adjusted net income' means the net income minus the sum of—

(A) The normal tax imposed by section 13.

(B) The credit provided in section 26(a) relating to interest on certain obligations of the United States and Government corporations.

(C) In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933), the amount allowed as a credit under section 26(d).

(D) In the case of a national mortgage association created under Title III of the National Housing Act, the amount allowed as a credit under section 26(e).

(2) The term 'undistributed net income' means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26(e), relating to contracts restricting dividends.

(b) IMPOSITION OF TAX.—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

17 per centum of the portion of the undistributed net income which is in excess of 20 per centum and not in excess of 40 per centum of the adjusted net income.

22 per centum of the portion of the undistributed net income which is in excess of 40 per centum and not in excess of 60 per centum of the adjusted net income.

27 per centum of the portion of the undistributed net income which is in excess of 60 per centum of the adjusted net income."

"Sec. 26 (Revenue Act of 1936). In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax— \* \* \*

(c) CONTRACTS RESTRICTING PAYMENT OF DIVIDENDS.—

(1) PROHIBITION ON PAYMENT OF DIVIDENDS.—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such

credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) **DISPOSITION OF PROFITS OF TAXABLE YEAR.**—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word 'debt' does not include a debt incurred after April 30, 1936.

(3) **DOUBLE CREDIT NOT ALLOWED.**—If both paragraph (1) and paragraph (2) apply, the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied."

The regulations involved are Article 26-2 of Treasury Regulations 94 (1936 Ed.), which, so far as material, provide as follows:

"ART. 26-2. Credit in connection with contracts restricting payment of dividends.—(a) The credit provided in Section 26(c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. The charter of a corporation does not constitute a written contract exe-

cuted by the corporation within the meaning of section 26(c). The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26(c)(1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26(c)(2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

If a corporation is restricted with respect to the payment of dividends by two or more contract provisions coming within section 26(c)(1), only the largest of the credits computed with respect to each of such provisions, and not their sum, shall be allowable under section 26(c)(1) and, for such purpose, if two or more credits are equal in amount, only one shall be taken into account. However, section 26(c)(3) provides that if both section 26(c)(1) and section 26(c)(2) apply, only the one of such paragraphs which allows the greater credit shall be applied, and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

(b) Prohibition on payment of dividends.—The credit provided in section 26(c)(1) is allowable only with respect to a written contract executed by the corporation prior to May 1, 1936, which expressly deals with the payment of dividends and operates as a legal restriction upon the corporation as to the amounts which it can distribute within the taxable year as dividends. If an amount can be distributed within the taxable year as a dividend—

(1) in one form (as, for example, in stock or bonds of the corporation) without violating the provisions of a contract, but can not be distributed within the taxable year as a dividend in another form (as, for example, in cash) without violating such provisions, or

(2) at one time (as, for example, during the last half of the taxable year) without violating the provisions of a contract, but can not be distributed as a dividend at another time within the taxable year (as, for example, during the first half of the taxable year) without violating such provision—

then the amount is one which, under section 26(c)(1), can be distributed within the taxable year as a dividend without violating such provisions.

The credit provided in section 26(c)(1) is equal to the excess of the adjusted net income as defined in section 14(a), over the aggregate of the amounts which can be distributed within the taxable year without violating the provisions of such contract. The requirement that the provisions of the contract expressly deal with the payment of dividends is not met in case (1) a corporation is merely required to set aside periodically a sum to retire its bonds, or (2) the contract merely provides that while its bonds are outstanding the current assets shall not be reduced below a specified amount. \* \* \*

(c) Disposition of profits of taxable year.—Under the provisions of section 26(c)(2), a corporation is allowed a credit in an amount equal to that portion of the earnings and profits of the taxable year which, by the terms of a written contract executed by the corporation prior to May 1, 1936, and expressly dealing with the disposition of the earnings and profits of the taxable year, it is required within the taxable year to pay in, or irrevocably to set aside for, the discharge of a debt incurred on or before April 30, 1936. The credit is limited to that amount which is actually so paid or irrevocably set aside during the taxable year pursuant to the requirements of such a contract.

Only a contractual provision which expressly deals with the disposition of the earnings and profits of the taxable year shall be recognized as a basis for the credit provided in section 26(c)(2). A corporation having outstanding bonds is not entitled to a credit under a provision merely requiring it, for example, (1) to retire annually a certain percentage or amount of such bonds, (2) to maintain a sinking fund sufficient to retire all or a certain percentage of such bonds by maturity, (3) to pay into a sinking fund for

the retirement of such bonds a specified amount per thousand feet of timber cut or per ton of coal mined, or (4) to pay into a sinking fund for the retirement of such bonds an amount equal to a certain percentage of gross sales or gross income. Such provisions do not expressly deal with the disposition of earnings and profits of the taxable year. A contractual provision, however, shall not be considered as not expressly dealing with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of 'net income,' 'net earnings' or 'net profits.'

The term 'debt' as used in section 26(c)(2) does not include an obligation of the corporation to a shareholder, as such, as distinguished from a creditor. Accordingly, amounts paid into, or set aside for, a sinking fund by a corporation for the retirement of preferred stock, pursuant to the terms of an agreement underlying the preferred stock issue, shall not be considered as set aside for discharge of a debt. An indebtedness evidenced by bonds or other similar obligations issued by a corporation is incurred as of the date such obligations are issued, and the amount of such indebtedness is the amount represented by the face value of the obligations. For the purpose of this article a bond or other similar obligation is not issued until it is executed and delivered to a person who holds it as a debt of the corporation. Bonds issued after April 30, 1936, in exchange in refunding a pre-existing issue represent debts incurred after April 30, 1936, within the meaning of section 26(c)(2)."

Section 501 of the Revenue Act of 1942 amends Sections 14 and 26 of the Revenue Act of 1936, as follows:

*SEC. 501. Additional Credits for Undistributed Profits Tax.*

(a) AMENDMENTS TO THE REVENUE ACT OF 1936.—

(1) Section 14(a)(2) of the Revenue Act of 1936 (relating to definition of undistributed net income) is amended to read as follows:

"(2) The term 'undistributed net income' means the adjusted net income minus the sum of (A) the

dividend paid credit provided in section 27, (B) the credit provided in section 26(c) relating to restrictions on payment of dividends, (C) except in cases where section 26(c)(1) is applicable, the deficit credit provided in section 26(f), and (D) the redemption credit provided in section 26(g)."

(2) Section 26(c) of the Revenue Act of 1936 (relating to credits of corporations) is amended by amending the heading to read as follows: "(c) RESTRICTIONS ON PAYMENT OF DIVIDENDS.—"; and by amending paragraph (3) to read as follows:

"(3) DEFICIT CORPORATIONS.—In the case of a corporation having a deficit in accumulated earnings and profits as of the close of the preceding taxable year, the amount of such deficit, if the corporation is prohibited by a provision of a law or of an order of a public regulatory body from paying dividends during the existence of a deficit in accumulated earnings and profits, and if such provision was in effect prior to May 1, 1936.

"(4) DOUBLE CREDIT NOT ALLOWED.—If more than one of the credits provided in the foregoing paragraphs (1), (2) and (3) apply, then the paragraph which allows the greatest credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied."

(3) Section 26 of the Revenue Act of 1936 (relating to credits of corporations) is amended by adding at the end thereof the following new subsections:

"(f) DEFICIT CREDIT.—The amount by which the adjusted net income exceeds the sum of (1) the earnings and profits accumulated after February 28, 1913, as of the beginning of the taxable year, and (2) the earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year). For the purposes of this subsection, earnings and profits of the taxable year shall be computed without diminution by the amount of the tax imposed under section 14, 102, 103 or 351 for such taxable year; and earnings and profits ac-

cumulated after February 28, 1913, as of the beginning of the taxable year, shall be diminished on account of the tax under section 14, 102, 103, or 351 for any previous taxable year only by the amount of such tax as computed under the amendments made by section 501 of the Revenue Act of 1942.

“(g) STOCK REDEMPTION CREDIT.—An amount equal to the portion of the recognized gain, realized within the taxable year and prior to March 3, 1936, from the sale or other disposition of a capital asset, which, pursuant to a contract, was distributed prior to such date to shareholders in redemption in whole or in part of preferred stock and which is not otherwise allowable as a credit under any other provision of this section or section 27.”

“(b) EFFECTIVE DATE OF AMENDMENTS.—The amendments made by subsection (a) shall be effective as of the date of the enactment of the Revenue Act of 1936.”

Subsequent to the trial and submission of briefs before the Tax Court, i.e., on April 21, 1943, the Commission promulgated the following T. D. No. 5263:

“PAR. 5. There is inserted immediately after article 26-3 [section 3.26-3, Title 26, Code of Federal Regulations] the following:

ART. 26-4. [Section 3.26-4, Title 3, Code of Federal Regulations, 1943 Sup.] DEFICIT CREDIT. — Section 26(f) is designed to be used particularly in those cases where the surtax on undistributed profits can not be avoided because the corporation has adjusted net income but has no accumulated earnings and profits at the beginning of the year and no earnings and profits of the taxable year on account of certain unallowable deductions, such as capital losses. In such a case a credit is allowed in the amount by which the adjusted net income exceeds the sum of the earnings and profits, if any, accumulated after February 28, 1913 (as of the beginning of the taxable year), and those of the taxable year, computed as of the close of such year, without regard to distributions made during the year, or to the amount of the surtax on undistributed profits imposed under



section 14, the graduated income tax or surtax imposed under section 102, the tax on citizens and corporations of certain foreign countries imposed under section 103, or the surtax on personal holding companies imposed under section 351, for the taxable year. In computing earnings and profits as of the beginning of the taxable year accumulated after February 28, 1913, the taxes just mentioned for any previous taxable year are to be deducted only as computed under the amendments provided by section 501 of the Revenue Act of 1942. If there is a deficit in the accumulated earnings and profits as of the beginning of the taxable year, or for the taxable year, such deficit shall not be taken into consideration in determining the credit allowable under section 26(f), and in such a case the earnings and profits as of the beginning of the taxable year, or the earnings and profits of the taxable year, shall be considered as zero.

The application of the provisions of section 26(f) may be illustrated by the following examples:

Example (1). The M Corporation on the accrual basis for the calendar year 1936 had a gross income of \$300,000, miscellaneous deductions of \$106,000, capital losses of \$92,000 of which only \$2,000 were deductible due to the provisions of section 117(d), and a normal tax liability under section 13 of \$28,840. Its adjusted net income was therefore \$171,160 (\$300,000 less \$106,000 less \$2,000 less \$28,840) while its earnings and profits of the taxable year computed after deducting the normal tax imposed by section 13 for such year but without diminution by the amount of the tax imposed for such year by section 14, 102, 103, or 351, were \$73,160 (\$300,000 less \$106,000 less \$92,000 less \$28,840). Assuming that the corporation had no accumulated earnings and profits as of December 31, 1935, it is allowed, in computing its undistributed net income subject to tax under section 14, a credit under section 26(f) of \$98,000, the amount by which the adjusted net income of \$171,160 exceeds the earnings and profits of the taxable year.

Example (2). If in the above example there was a contract in existence prior to May 1, 1936, under which the M Corporation could not distribute dividends in excess of \$150,000 during the calendar year 1936, see-

tion 26(c)(1) is applicable and allows a credit of \$98,000, namely, an amount equal to the excess of the adjusted net income, \$171,160, over the aggregate of the amounts which can be distributed within the taxable year as dividends, \$73,160. Accordingly, the credit allowable under section 26(f) is inapplicable.

Example (3). Assume in example (1) that the M Corporation had a deficit of \$20,000 in accumulated earnings and profits as of December 31, 1935, and that the State law prohibited dividend distributions during the existence of a deficit in accumulated earnings and profits. In addition to the deficit credit of \$98,000 provided in section 26(f), the M Corporation, under paragraph (3) of section 26(c) is allowed a credit of \$20,000, the amount of the deficit in accumulated earnings and profits as of December 31, 1935."

### Summary of Argument

By stipulation petitioner had a deficit in earnings and profits on January 1, 1936, and was therefore entitled to a deduction of a "Deficit Credit" under the relief provisions of the Revenue Act of 1942 applicable retroactively to the Undistributed Profits Tax Sections of the 1936 Act.

The decision of the Tax Court that "Deficit Credit" deals only with positive earnings and profits and that the "colloquial meaning of the heading 'Deficit Credit'" is to be ignored is squarely contrary to the common ordinary meaning of the term "Deficit".

Petitioner did have a contract restricting the payment of dividends consisting of three papers taken together, i.e.:

- (a) the letter of Bonbright,
- (b) the telegram of Perry,
- (c) the merger agreement.

The decision and stated findings of the Tax Court were not such as to preclude consideration of petitioner's appeal under the decisions of this Court in the *Dobson* and

*Heininger* cases because all the necessary facts were stipulated and the only matters decided by the Tax Court in this case are purely matters of law.

The decision of the Circuit Court of Appeals as to Section 26(f) of the Revenue Act of 1936 as amended by the 1942 Act is in conflict with the decision of the same Court in *van Ameringen-Haebler v. Commissioner*, 132 F. (2d) 855, and as to Section 26(c) is in conflict with the decision of the Circuit Court of Appeals, Sixth Circuit, in *Automotive Parts Company v. Commissioner*, 134 F. (2d) 420.

## ARGUMENT

### I

**The opinion of the Tax Court that "Deficit Credit" deals only with positive earnings and profits and that the colloquial meaning of the heading of Section 26(f) "Deficit Credit" is to be ignored is erroneous.**

The Commissioner stipulated that petitioner had a deficit in earnings and profits as of January 1, 1936 showing a deficit of \$55,305.77 (fol. 92). The stipulated adjustments resulting in this deficit are set forth in the record (fols. 142, 143).

For the avowed purpose of granting relief to taxpayers from the harsh provisions of the undistributed profits tax sections of the Revenue Act of 1936, i.e., Sections 14 and 26, coupled with the rule of strict construction laid down in *Helvering v. Northwest Steel Rolling Mills*, 311 U. S. 46, there was incorporated in Revenue Act of 1942 under Section 501 a new subdivision to be retroactive and to be known as Section 26(f) of the Revenue Act of 1936 as amended. This section is set forth under Statutes at pages 19-20 of this brief.

Simply stated and applied to the agreed figures in this case, taxpayer's contention is set forth as follows:

## YEAR 1936

The amount by which the adjusted net income  
of ..... \$75,946.41

*exceeds the sum of*

- (1) the earnings and profits  
accumulated after Feb. 28,  
1913 as of the beginning  
of the taxable year..... \$55,305.77\*

*and*

- (2) the earnings and profits of  
the taxable year without  
diminution for distribu-  
tions made..... 87,984.01

*Sum of (1) and (2)..... 32,678.24*

*Deficit Credit..... \$43,268.17*

\* denotes red figure or deficit.

In the face of the foregoing figures, which are undisputed, and solely as a matter of law, the Tax Court held:

(a) "Deficit Credit", the title of Section 26(f) of the Revenue Act of 1936, as amended, does not mean what it says, but we must look to the language which must "dominate the section rather than a colloquial meaning of the heading deficit credit" (fol. 322).

(b) The "language" referred to by the Tax Court (fol. 322) is discussed in the opinion as follows: "According to the letter of the section, the credit is expressly defined without reference to a possible accumulated deficit instead of actual earnings for the prior period. It deals only with positive earnings and profits."

We do not understand these statements of the Tax Court. They appear to be conflicting. In the first sentence the Court says the credit does not refer to accumulated deficit instead of actual earnings and then in the next sentence states: "It deals only with positive earnings and profits."

We present an analysis of Section 26(f) as follows:

The title "Deficit Credit" is clear beyond doubt. The section is quoted in part:

"The amount by which the adjusted net income exceeds the sum of (1) the earnings and profits accumulated after February 28, 1913, as of the beginning of the taxable year and (2) the earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year) \* \* \*."

In the light of the foregoing quotation we challenge the decision of the Tax Court in referring to

(a) "positive earnings and profits" (fol. 322). There is no reference to "positive" in the statute.

(b) We fail to find any statement in the statute that "according to the letter of the section the credit is expressly defined without reference to a possible accumulated deficit" (fol. 322), or that

(c) "It does not contemplate a minus or red figure in lieu of accumulated earnings." We find neither "minus" nor "red", nor "in lieu of accumulated earnings" in the statute.

As a matter of common fairness we should not have to "contemplate" the words of a tax relief statute which are as plain as day. Furthermore, we fail to understand how a deficit can be anything but a minus quantity. The reference of the Tax Court to the Ways and Means Report (fol. 323) is inconclusive. The statute by its terms applies to all corporations and is not limited to a personal holding company which is referred to in the Committee Reports. But why examine Committee Reports when we have a clear decisive statute? The further reference of the Tax Court (fol. 323) to restriction upon this taxpayer by reason of contract, statute or regulation is irrelevant to any issue presented.

In view of the foregoing petitioner is entitled to the benefit of the relief provisions of Section 26(f) under the facts stipulated by the Commissioner.

## II

**The decision of the Circuit Court of Appeals in this case is squarely contrary to the decision of the same Court in *van Ameringen-Haebler v. Commissioner*, 132 F. (2d) 855, under identical facts.**

Counsel in this case was counsel for *van Ameringen-Haebler v. Commissioner*, 132 F. (2d) 855. As far as the deficit credit question under Section 26(f) of the Revenue Act of 1936 is concerned the facts are identical.

The Revenue Act of 1942 containing the "Deficit Credit" amendment of the 1936 Act became law just before the argument of the *van Ameringen-Haebler* case in the Circuit Court of Appeals, Second Circuit. A computation identical in form and scope to that set forth in Point I of this brief was presented to the Court in that case. The Circuit Court of Appeals reversed the Commissioner and remanded the case to the Tax Court. The Commissioner then settled and paid taxpayer in the *van Ameringen-Haebler* case and an order to that effect was entered in the Tax Court on April 19, 1943.

It is of interest that Treasury Decision T. D. 5263 (quoted under Statutes herein) was approved April 21, 1943 by the Treasury long after the enactment of the Revenue Act of 1942 on October 21, 1942. Petitioner contends that this Treasury Decision is squarely in conflict with the statute. The reasoning, statements, and examples of T. D. 5263 closely parallel the decision of the Tax Court in this case and are equally unsound and erroneous for the reasons set forth in Section I of this brief.

## III

Petitioner did have a contract restricting the payment of dividends consisting of three papers taken together, i.e.,

- (a) the letter of Bonbright
- (b) the telegram of Perry
- (c) the merger agreement

and petitioner is entitled to a credit either under Section 26(f) (Points I and II) or under Section 26(c) (1) on account of a contract restricting the payment of dividends.

Section 14 of the Revenue Act of 1936 imposes a surtax on the so-called "undistributed net income" of a corporation. Section 26(c)(1) of the Revenue Act of 1936 imposes four conditions to the allowance of credit in computing the surtax on undistributed profits under Section 14 of the Revenue Act of 1936. These four requirements are that there must be:

- (1) A written contract;
- (2) The contract must have been executed by the corporation prior to May 1, 1936;
- (3) The contract must contain a provision expressly dealing with the payment of dividends;
- (4) Dividends cannot be paid without violating the contract provision.

Petitioner has complied with every requirement.

Petitioner's contract was in writing. There are three documents which taken together constitute the complete written contract in this case. These documents are:

- (a) The letter of October 14, 1935, Bonbright to Colonel Perry (fol. 95);

(b) Colonel Perry's telegram to Bonbright of October 16, 1935 (fol. 101);

(c) The statutory form of agreement of merger dated December 12, 1935 (fol. 103).

The Bonbright-Perry letter contained the terms upon which Mr. Rogers, as a non-noteholding stockholder would consent to the merger of Boltin and BIMC. These terms were agreed to by Mr. Bonbright and Colonel Perry, as president and vice-president respectively of BIMC, and owners of 70% of the stock and 90% of the note indebtedness (fols. 84, 388, 392).

The merger agreement (fol. 103) and the correspondence referred to were all executed by the corporation prior to May 1, 1936, namely, in December and October, 1935. The merger agreement was executed by the respective corporations and by a majority of their respective boards of directors (fol. 126). The letter and telegram reflecting the agreement reached with Mr. Rogers were executed by the president and vice-president respectively of BIMC. The accord set forth therein was one made by all of the note-holders, who were the principal creditors of the corporation and were also stockholders and directors on one side, and Mr. Rogers a non-noteholding non-creditor stockholder on the other side.

The noteholders had been insisting upon a plan of merger which would require the payment in full of all outstanding notes before any dividends could be paid upon the stock of the corporation. Mr. Rogers, on the other hand, as a non-noteholder, had been insisting that payment of some small amount of dividends be permitted in each year even though there were outstanding notes. He insisted that after the corporation had retired \$150,000 worth of notes in each year and after it had paid interest on the remaining outstanding notes, it be bound to pay a dividend of 12¢ per share on the stock before it could retire any additional notes.



A compromise was arrived at, under the terms of which \$150,000 worth of notes were to be redeemed first out of available funds in each year, then interest was to be paid on the remaining outstanding notes, then a dividend of 12¢ per share on the stock of the corporation should be paid, and if additional funds were available in any year, such additional funds could not be distributed by the payment of further dividends but were required to be used for the further retirement of notes (fol. 393). That is the agreement reached between Mr. Bonbright and Mr. Rogers referred to in Mr. Rogers' letter to Mr. Bonbright of October 11, 1935, and reflected in the Bonbright-Perry letter of October 14, 1935, agreed to in the Perry-Bonbright telegram of October 16, 1935, and that was the obligation assumed by BIMC in the merger agreement.

The letter of October 14, 1935, from Bonbright to Perry expressly states that one of the conditions of the merger shall be that BIMC shall pay 12¢ per share per annum in dividends on the stock of the corporation and any additional funds available in any year shall go toward the further retirement of the notes. Accordingly by the terms of this agreement, so long as any notes were outstanding, no more than 12¢ per share could be declared and paid in any year as dividends on the stock of the corporation. This obligation of the corporation was assumed in paragraph "Seventh" of the merger agreement along with all of the other debts, liabilities and duties of the corporations which were parties to the merger agreement (fol. 114). That this was a binding contract upon BIMC is clearly evident from the resolution passed by the Board of Directors of BIMC at the meeting of August 14, 1936, at which a dividend of 12¢ per share was declared on the corporation's outstanding stock. The contract contains a provision expressly dealing with the payment of dividends.

Without this agreement with respect to the payment of dividends, there would have been no merger since Mr. Rogers had steadfastly refused to consent to the merger unless and until some binding provision was made to allow

stockholders to receive some dividends on their stock prior to the complete retirement of the outstanding notes (fol. 392). The agreement was that 12¢ per share could be paid in dividends in each year. All other available funds in any year were required to be used for the retirement of notes. Any dividend payment in excess of 12¢ per share in any year would have violated this provision of the written contract. The corporation and directors have carried out this agreement to date. In no year has more than 12¢ per share been distributed in dividends. In no year were notes in excess of \$150,000 retired unless dividends of 12¢ per share were paid.

Accordingly, petitioner has strictly complied with each and every requirement imposed by Section 26(c)(1) of the Revenue Act of 1936 and is entitled to the credit allowed by that section.

The Tax Court bases its opinion on the narrow ground that the so-called agreement restricting the payment of dividends was not signed by the corporation and then concludes that the so-called agreement was not binding on the corporation, petitioner herein (fols. 316-319).

This viewpoint is refuted by the facts:

(1) It was customary for Bonbright to write letters on his own letterhead pertaining to taxpayer and to Boltin (fol. 392);

(2) It was customary for Rogers to write letters on Rogers & Whitaker stationery (fols. 154, 155);

(3) Bonbright was president and director of B. I. M. C., owned 354 out of 1,000 shares of Boltin in 1935, held \$454,162.92 of notes (fols. 305, 306);

(4) Bonbright determined such matters for taxpayer as:

(a) attorneys' fees (fol. 155);

(b) selection of counsel for taxpayer, Douglas & Armitage (fol. 150);

(c) directing counsel for corporation to prepare contract of merger of B. I. M. C. and Boltin (fol. 150);

(d) informing counsel for corporation of approval of "this plan of merger and the arrangements as you and he have agreed" (fol. 152) and " \* \* \* I will be glad to have you wire your approval in order that Mr. Armitage may proceed without further delay in the preparation of the final papers" (fol. 101);

(e) negotiation on behalf of taxpayer as president with a stockholder with whom there was a conflict of interest because of ownership of notes by three of the four stockholders of the corporation;

(f) settlement of the year-old controversy with Rogers with respect to,

dividends not in excess of 12¢ per share per year to be paid by taxpayer and the amount of interest to be paid on the notes to be assumed by the taxpayer (fols. 96-101);

(g) signing of the merger agreement as president and director, and seeing that it was carried out (fols. 103-141).

After all, these four stockholders—there were only four persons concerned—were businessmen of wide experience and

(a) the letter of Bonbright (fols. 95-101),

(b) the telegram of Perry (fol. 102), and

(c) the merger agreement (fols. 103-141)

constitute the written agreement in this case. The statutory form of agreement of merger (fol. 103) merely carried out and implemented the plan of merger agreed to as set forth in the so-called Bonbright letter (fols. 95-101). For in-

stance, various matters contained in the plan are specifically incorporated therein, i. e.:

- (a) "the proposed merger" (fol. 97);
- (b) "cost to us all as shareholders" (fol. 98);
- (c) interest on notes,  $3\frac{1}{2}\%$  (fol. 117);
- (d) the number of shares in conformity with the plan (fol. 116);
- (e) conversion of notes (fol. 118);
- (f) assumption by taxpayer of "all debts, liabilities and duties of Boltin, Inc." (fol. 114).

Petitioner asserts that the letter of Bonbright, Perry's telegram and agreement of merger signed by all, i. e., Bonbright, Perry, Easley and Rogers collectively and the corporation, constitute:

- (a) a written contract
- (b) executed by the corporation prior to May 1, 1936
- (c) expressly dealing with the payment of dividends
- (d) under which dividends cannot be paid without violating the contract provisions.

Thus, under a strict construction, all the requirements of the statute are met.

The Tax Court opinion states that this agreement was not enforceable against the corporation. Although the statute makes no mention of an enforceable agreement as such, it is our opinion that the agreement was and is enforceable. If more dividends were paid than 12¢ per share, the note-holders could successfully enjoin such payment. If no dividends were paid, a stockholder could restrain the retirement of the notes beyond \$150,000 per annum. After all, there were only four persons concerned, and their intentions should govern. The minutes of directors' meeting

(fols. 145-149) at which the first 12¢ dividend was voted show conclusively how the directors construed the obligations of the taxpayer in August, 1936.

The Tax Court's claimed distinction is without substance because Bonbright, Perry, Easley and Rogers, after agreeing to the plan specified in Bonbright's letter, then, as officers and directors, executed the agreement of merger (fol. 126, where Bonbright signed as president of taxpayer and as director of taxpayer). Likewise, Easley, Perry and Rogers signed as directors of taxpayer.

The Tax Court was apparently confused by the fact that Bonbright was a stockholder in Boltin, which owned all the stock of B. I. M. C., but overlooks the fact that Bonbright was president of B. I. M. C., the corporation which was to be bound by the dividend restriction (fol. 125).

#### IV

**The decision of the Circuit Court of Appeals on the question of contracts restricting the payment of dividends is in conflict with the decision in the Circuit Court of Appeals for the Sixth Circuit in *Automotive Parts Company v. Commissioner*, 134 F. (2d) 420, and with the decision in the Circuit Court of Appeals for the Eighth Circuit in *Harding Glass Co. v. Commissioner*, 142 F. (2d) 41.**

The opinion of the Tax Court to the effect that taxpayer did not execute a written contract prior to May 1, 1936, which expressly restricted the payment of dividends (fol. 316), seems to have been predicated largely upon the theory that there must be one instrument and that the so-called contract restricting the payment of dividends could not be effected by an exchange of communications. The decision in *Automotive Parts Co. v. Commissioner*, 134 F. (2d) 420, is similar to the facts presented herein.

In that case there were a series of writings regarding a restriction on dividends, and in the opinion on page 422 the Court stated:

"In our opinion, the telegram and letters between petitioner and its creditor, the Brake-Blok Corporation, were more than an exchange of tentative ideas or preliminary negotiations regarding a restriction on the payment of dividends and the documents are sufficiently definite and explicit to constitute a written, enforceable contract by petitioner's creditor, which would have been violated by respondent had it paid dividends in excess of \$6,000.

The order of the Board is reversed. \* \* \*

The opinion of the Tax Court (fol. 320) states that the *Automotive* case is not in point and sustains its view by stating that the corporation in itself in our case did not make a promise, and the understanding among the shareholders and creditors cannot be imputed to it for purposes of the tax credit. This statement is squarely contrary to the admitted facts with respect to the Merger Agreement, the letters and telegram which we have heretofore pointed out constituted the agreement which is substantially identical with the facts in the *Automotive* case.

To the same effect is the recent decision in *Harding Glass Co. v. Commissioner*, 142 F. (2d) 41 (April, 1944), decided by the Circuit Court of Appeals for the Eighth Circuit. The Court at page 44 of the opinion stated: "In order to meet the terms of the statute it is not necessary that the contract relied on be contained in one writing." Further, the Court stated: "The argument on behalf of the Commissioner that the contract of April 30, 1936 fails to meet the requirements of Section 26(c)(1) because not made by the Harding Company with one of its creditors is untenable."

In our case there is but one question, i.e.: Was Bonbright acting for the corporation? The record shows he was president of petitioner, he fixed attorney's fees for the corporation, the amount of interest to be paid on notes

and other corporate problems were decided by him as president. Could he bind the corporation? The answer is he did; he employed attorneys. In any event, the Merger Agreement which he signed as president was held up for a year because of the dispute over dividends. This certainly was restriction in any event and, besides, there were only four persons concerned, Bonbright, Perry, Easley and Rogers.

### CONCLUSION

Therefore the questions herein are of general importance and of substance relating to the construction of statutes of the United States and more particularly petitioner begs leave to quote from the opinion in *Denholm & McKay Beauty Co. v. Commissioner*, 139 Fed. (2d) 545, where the Court said:

"Whether the Dobson case was intended to introduce a revolutionary limitation upon the scope of judicial review as previously understood and practiced, or merely to reemphasize that under the revenue act the decisions of the Tax Court may be reversed only if 'not in accordance with law', 26 U. S. C. A. INT. REV. CODE, §1141(c)(1), is a question which will no doubt perplex the circuit courts of appeals until further light is shed upon the Dobson case by later decisions of the Supreme Court. The question in the Dobson case, whether the payments which the taxpayer received in the taxable year constituted income to him or were in the nature of a return of capital, seems to have been regarded by the Supreme Court as merely an issue 'of proper tax accounting' and, as such, a question of fact on which the Tax Court's decision is final if supportable on a rational basis."

And further petitioner believes the Circuit Court of Appeals, Second Circuit, believed it was precluded by the decisions of this Court in *Commissioner of Internal Revenue v. Heininger*, 88 L. Ed. 197, and *Dobson v. Commis-*

*sioner of Internal Revenue*, 88 L. Ed. 179, from reviewing the matters presented herein, and petitioner prays that this application be granted.

Respectfully submitted,

HUBERT E. ROGERS,  
JOHN F. CONDON, JR.,  
Solicitors for Petitioner.







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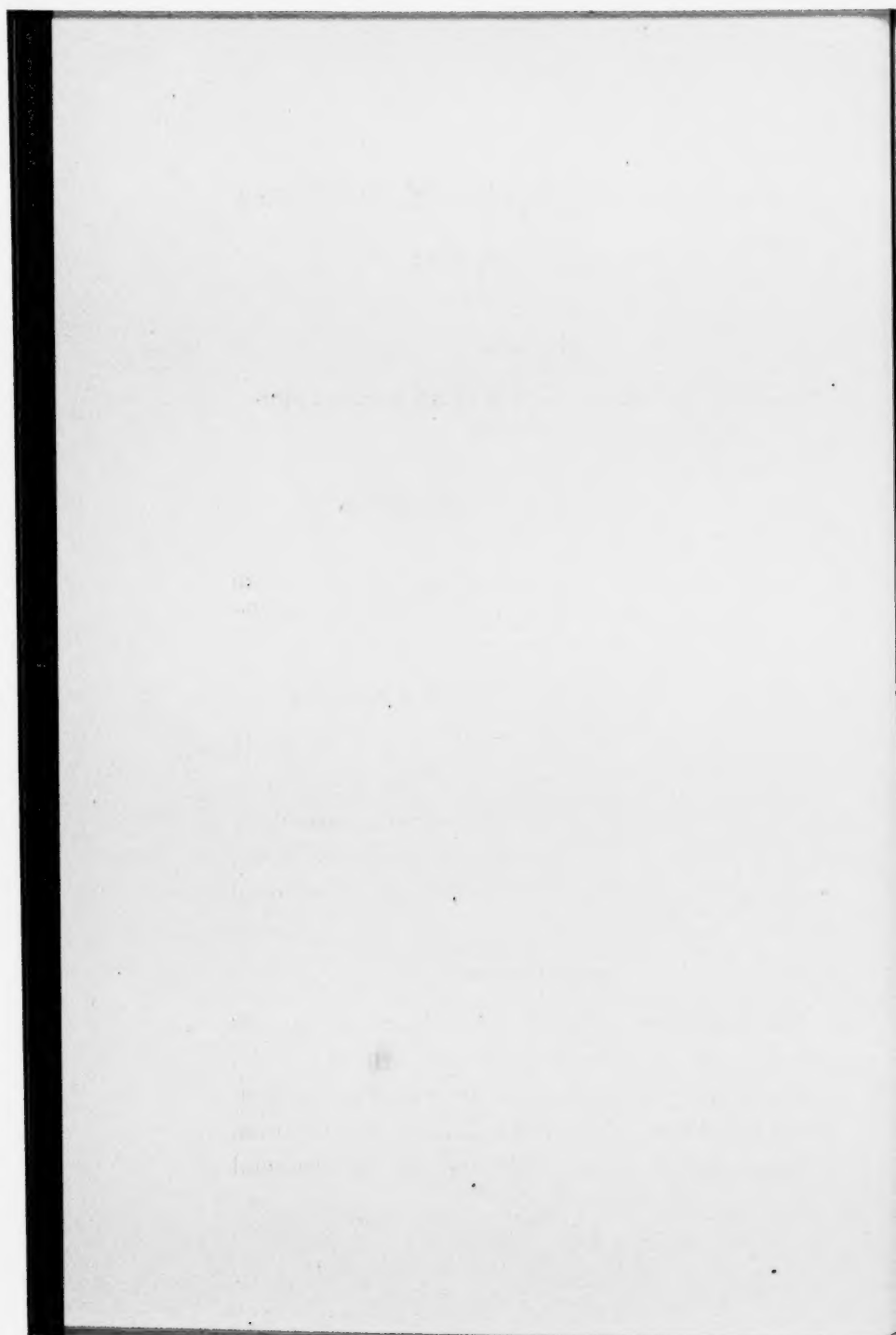
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Art. 26-4 .....	9, 25

(1)



# **In the Supreme Court of the United States**

OCTOBER TERM, 1944

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No. 436

**BOLIVIAN INTERNATIONAL MINING CORPORATION,  
PETITIONER**

*v.*

**COMMISSIONER OF INTERNAL REVENUE**

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***ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED  
STATES CIRCUIT COURT OF APPEALS FOR THE SECOND  
CIRCUIT***

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## **BRIEF FOR THE RESPONDENT IN OPPOSITION**

### **OPINIONS BELOW**

The opinion of the Tax Court (R. 101-108) is reported in 1 T. C. 1110. The memorandum decision of the Circuit Court of Appeals (R. 136), affirming the opinion of the Tax Court, is reported in 142 F. 2d 556.

### **JURISDICTION**

The judgment of the Circuit Court of Appeals was entered on June 7, 1944 (R. 136-137). The petition for a writ of certiorari was filed on September 6, 1944. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial

Code, as amended by the Act of February 13, 1925.

#### QUESTIONS PRESENTED

1. May a deficit in earnings and profits from prior years, existing at the commencement of a given taxable year, be considered in determining the credit allowed under Section 26 (f) of the Revenue Act of 1936, as amended by Section 501 (a) (3) of the Revenue Act of 1942; or, in such event, are the earnings and profits as of the commencement of the taxable year, to be taken as zero?

2. Did taxpayer execute a written contract prior to May 1, 1936, expressly restricting payment of dividends within the meaning of Section 26 (c) (1) of the Revenue Act of 1936?

#### STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Appendix, *infra*, pp. 15-27.

#### STATEMENT

The Tax Court's findings of fact may be summarized as follows:

Boltin, Inc., during 1934 and 1935 was a Delaware corporation, the shareholders of which were:

	Shares
Irving W. Bonbright.....	354
O. B. Perry.....	354
George A. Easley.....	185.8
A. G. Dibbs, as nominee for Hubert E. Rogers.....	108.2
	<hr/> 1,000.0

In turn, Boltin, Inc., owned all of the capital stock of taxpayer. In 1935, Bonbright was president, Perry, vice president, one Ericson, secretary, and Dibbs, treasurer of taxpayer. In the same year, Boltin, Inc., was indebted on notes to three of its shareholders, namely, Bonbright, Perry, and Easley in an amount in excess of \$1,000,000. It was not indebted to Rogers. In 1934, a proposed merger of Boltin, Inc., into taxpayer was under discussion between Rogers, Bonbright, and Perry. Easley was present at many of the discussions. Rogers objected to any plan which contemplated paying off the note indebtedness to the other stockholders after the proposed merger before payment of dividends on taxpayer's stock to all its shareholders. (R. 102-103.) On October 14, 1935, Bonbright, in Rogers' presence, wrote the following letter to Perry in San Francisco (R. 103-104):

MY DEAR PERRY:

This morning I am in receipt of your letter of the 10th October; also, of a letter from Rogers in which he accepts, without qualification, the proposed compromise conditions named in my letter to him of the 11th October, a copy of which was sent to you by air mail on that day, together with the original of his letter to me of the 10th October.

\* \* \* \* \*

Under the plan as now agreed to, subject to your approval, funds of the Company as

made available through the setting aside of depletion reserve, etc., to the extent of \$150,000 per year, will be used toward retirement of the new notes; interest at the rate of  $3\frac{1}{2}$  per cent. per annum on said notes will then be paid, and, if additional funds are available, twelve cents per share per annum will be declared in dividends on the approximately 160,000 shares of B. I. M. C. stock. Any funds available in any year, after provision of the items named above, to go toward the future retirement of the notes.

You are correct in your assumption as to what I meant in my letter to Mr. Rogers about "elimination of any stock not required for immediate purposes of the merger." There will be no stock beyond what is required to satisfy the proposed deliveries to Boltin shareholders and the amount required to be held in the treasury for possible conversion of notes.

Before this letter reaches you, you will doubtless have received the correspondence above referred to, namely, Mr. Rogers' letter of October 10th, and copy of my reply of October 11th. And I hope after reading those letters and this one, you will have a clear picture in your mind.

To make sure that all of our minds have met with regard to the points I have covered in this letter, I am sending a copy to Mr. Rogers, and one to Mr. Armitage, and if you do not hear to the contrary by wire, you will know that all here are in agreement. And, in that case, I will be glad to



have you wire your approval in order that Mr. Armitage may proceed without further delay, in the preparation of the final papers.

With kindest regards,

Yours very truly,

IRVING W. BONBRIGHT.

Perry, on October 16, 1935, wired Bonbright (R. 104):

Your letter October fourteenth regarding Boltin Bimco merger stop I approve plan to which your letter refers

O. B. PERRY.

At the time Bonbright's letter was written, he had received the following letter dated October 11, 1935, from Rogers (R. 105):

I have just received your letter of this date.

Your suggested amendments to the plan, as well as to the matter of compensation which you propose, are entirely satisfactory to me.

On December 24, 1935, a formal agreement of merger between Boltin, Inc., and taxpayer, dated December 12, 1935, was executed by the corporations and by a majority of their respective boards of directors constituting practically all the stockholders and creditors, which contained the following provision (*ibid.*):

SEVENTH. All rights of creditors and all liens upon the property of either of said corporations shall be preserved unimpaired, and all debts, liabilities and duties

of BOLTIN, INC., shall thenceforth attach to said BOLIVIAN INTERNATIONAL MINING CORPORATION, the continuing corporation, and may be enforced against it to the same extent as if the said debts, liabilities and duties had been incurred or contracted by it.

On August 14, 1936, the taxpayer's directors adopted the following resolution (R. 105-106):

RESOLVED that in accordance with the terms of the agreement of merger and consolidation of Boltin, Inc., and Bolivian International Mining Corporation, the escrow agreement dated the 10th day of March, 1936, and the stockholders' agreement of October 14, 1935, that a dividend of 12¢ per share be paid on this Corporation's outstanding shares of stock (excluding 100,294 shares of stock deposited with the escrow agent pursuant to the terms of escrow agreement), and that the officers of the Corporation be and they hereby are directed to pay such dividend on the 21st day of August, 1936 to the registered holders of the shares of the Corporation as of the 19th day of August, 1936.

Taxpayer redeemed notes in 1936 and 1937 in the amounts of \$103,838 and \$299,100, respectively, and paid 12 cents per share dividend in both years. No dividends were thereafter paid in excess of that amount. (R. 106.)

The Tax Court found as a fact that taxpayer did not execute a written contract prior to May 1,

1936, which expressly restricted the payment of dividends (*ibid.*).

At the commencement of the taxable year (January 1, 1936), taxpayer had a deficit from prior years in the amount of \$55,305.77. For the year 1936, its adjusted net income was \$75,946.41. Its 1936 earnings and profits as adjusted in the Commissioner's deficiency notice were \$87,984.01. (R. 106.)

#### ARGUMENT

We submit that the decision below is correct, that there is no conflict and that the questions raised are neither novel nor important.

1. A deficit in accumulated earnings and profits of taxpayer as of the beginning of the taxable year cannot be taken into consideration in determining the credit allowance under Section 26 (f) of the Revenue Act of 1936, as amended by Section 501 (a) (3) of the Revenue Act of 1942 (see Appendix, *infra*, p. 19). Where such deficit exists, earnings and profits, as of the beginning of the taxable year, must be treated as zero. A Treasury Decision<sup>1</sup> specifically regulates the point here in question in accordance with the holding of the court below, and completely dis-

<sup>1</sup> T. D. 5263, 1943 Cum. Bull. 1003, which added Article 26-4 to Treasury Regulation 94 (Appendix, *infra*, pp. 25-27), providing in part:

"If there is a deficit in the accumulated earnings and profits as of the beginning of the taxable year, or for the taxable year, such deficit shall not be taken into consid-

poses of taxpayer's contention. The legislative history of the statute shows that it was designed to aid a corporation whose net income for a given taxable year exceeded accumulated and current earnings because of certain unallowable deductions, such as capital losses, and which, thus, might be subject to the undistributed profits surtax, even though it had distributed all of its accumulated and current earnings.<sup>2</sup> The Treasury

eration in determining the credit allowable under section 26 (f), and in such a case the earnings and profits as of the beginning of the taxable year, or the earnings and profits of the taxable year, shall be considered as zero."

This Treasury Decision was cited to the court below; apparently it was not before the Tax Court at the time its opinion was rendered. However, the ruling of the Tax Court entirely accords with the regulation.

<sup>2</sup> See H. Rep. No. 2333, 77th Cong., 2d Sess., p. 170, wherein it is stated that—

"Under section 14 of the Revenue Act of 1936 corporations in general were subject to surtax at various rates from 7 to 27 percent of their undistributed net income, even though such income was in excess of accumulated and current earnings or profits. In such a case the tax could not be avoided even if distributions were made to shareholders. This result was primarily due to the fact that section 117 (d) of the Revenue Act of 1936 limited capital losses to \$2,000 and section 27 (a) and (h) operated to disallow any credit where a distribution did not constitute a taxable dividend. Section 115 of the act provided that the term "dividend" means a distribution from earnings or profits, either those accumulated after February 28, 1913, or those realized during the current taxable year. The purpose of the undistributed profits tax was to force the payment of taxable dividends. Where a corporation has no earnings or profits, it cannot make a taxable dis-

Decision T. D. 5263, Article 26-4, Appendix, *infra*, pp. 25-27) expresses the same interpretation of the statutory intent. To permit taxpayers with accumulated deficits in earnings and profits as of the beginning of a taxable year to obtain a credit by deducting these deficits from the earnings and profits of the current year, would create an arbitrary and aimless discrimination against other taxpayers, not having such deficits. Under such a construction, contrary to the plain intent of the statute, a corporation might claim a credit even though possessed of current earnings, which it could distribute as dividends.<sup>3</sup> To the same effect as the instant case is the decision of the Tax Court in *Shellabarger Grain Products Co. v. Commissioner*, 2 T. C. 75, 84, appeal now pending in the Circuit Court of Appeals for the Seventh Circuit.

The decision of the court below in *Van Ameringen-Haebler, Inc. v. Helvering*, 132 F. 2d 855 (Pet. 9, 23, 26) is in no way inconsistent with or even relevant to its holding in the present case.

tribution which would constitute a dividend allowable as a dividend credit in computing the undistributed net income subject to the surtax."

See also S. Rep. No. 1631, 77th Cong., 2d Sess., p. 244.

<sup>3</sup> Where a taxpayer is prohibited by law from paying dividends during the existence of a deficit in accumulated earnings and profits, a credit is authorized under Section 26 (c) (3) of the Revenue Act of 1936, as amended by Section 501 of the Revenue Act of 1942 (Appendix, *infra*, p. 18). However, no such claim has ever been made in this case.

There, the court did not construe Section 26 (f), but, on the Commissioner's application, remanded the case to the Tax Court so that it might consider this and the other retroactive amendments which had not been before it on the original hearing.

2. Taxpayer did not execute a written contract prior to May 1, 1936, expressly restricting the payment of dividends within the meaning of Section 26 (c) (1) of the Revenue Act of 1936 (Appendix, *infra*, pp. 16-17). It has repeatedly been held that this Section must be strictly construed, since it grants a special deduction or exemption from a generally imposed surtax (Revenue Act of 1936, Sec. 14, Surtax On Undistributed Profits, Appendix, *infra*, pp. 15-16). *E. g.*, *Helvering v. Northwest Steel Mills*, 311 U. S. 46, 49. Again, since it is a special credit in the nature of a deduction, the taxpayer must sustain the burden of showing compliance with its exact terms (*Helvering v. Ohio Leather Co.*, 317 U. S. 102, 106; *White v. United States*, 305 U. S. 281, 292; *New Colonial Ice Co. v. Helvering*, 292 U. S. 435, 440; *Buffalo Slag Co. v. Commissioner*, 131 F. 2d 625, 626 (C. C. A. 2d); *Commissioner v. Oswego Falls Corp.*, 137 F. 2d 173, 176 (C. C. A. 2d)). The Tax Court, weighing the evidence, found as a fact that taxpayer did not execute a written contract prior to May 1, 1936, which expressly restricted the payment of dividends (R. 106-107). Thus, if, as taxpayer claims, the record contains any contrary evidence

or permits contrary inferences, these have been resolved by the trier of the facts against taxpayer and the finding of the Tax Court that "We can not find from the evidence that there was such a contract" (R. 106) is conclusive. *Dobson v. Commissioner*, 320 U. S. 489, rehearing denied, 321 U. S. 231.<sup>4</sup> In any event, however, upon the record it is difficult to perceive how any other conclusion could have been reached. Taxpayer rests the asserted contract (Pet. 27-28) upon three papers consisting of: (a) the letter of October 14, 1935, from Mr. Bonbright to Colonel Perry; (b) Colonel Perry's telegram to Bonbright of October 16, 1935; and (c) the merger agreement, dated December 12, 1935 (see Statement, *supra*, pp. 3-6). The Tax Court was justified in finding that the letter and telegram were not corporate acts, but merely communications based on personal interest, from one stockholder and creditor of Boltin, Inc. to another, respecting the proposed merger of that company into its subsidiary, the taxpayer. The letter of October 14th is written on the personal stationery of Bonbright, its author, and is signed by him as an individual (R. 32-34). Intrinsically it evidences negotiations between these individuals in support of their personal interests,

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<sup>4</sup> The court below wrote no opinion and there is accordingly no basis for taxpayer's claim (Pet. 9-10) that the *Dobson* case has been erroneously construed by the court below to deprive taxpayer of a review on a question of law.



as stockholders, and not on behalf of or in the interest of any corporate entity. Indeed, the resolution of taxpayer's directors, adopted August 14, 1936 (see Statement, *supra*, p. 6) (R. 105-106), refers, in so many words, to the letter of October 14, 1935, as "the stockholders' agreement of October 14, 1935".<sup>5</sup> The merger agreement (R. 105) contains no word on the subject of dividends, and neither court below can fairly be claimed to have erred in holding that it did not constitute an express restriction of dividends executed by taxpayer.

A stockholders' agreement is not a corporate promise, and had Perry, Bonbright or Rogers sold their shares, neither the new stockholders nor taxpayer corporation would have been bound by any restriction on the declaration of dividends (see R. 106-107). Compliance with the statute requires an enforceable corporate contract (*Central West Coal Co. v. Commissioner*, 132 F. 2d 190, 192 (C. C. A. 7th), certiorari denied, 318 U. S. 778, and Treasury Regulations 94, Article 26<sup>1</sup>-2 (b), Appendix, *infra*, pp. 20-24), not a mere stockholders' agreement. The decision of the Ninth Circuit Court of Appeals in *Anglim v. Acme Brew-*

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<sup>5</sup> If for no other reason, this resolution cannot, of course, itself constitute a contract within the statute, since it was made subsequent to May 1, 1936, the crucial date under Section 26 (c) (1) (Appendix, *infra*, pp. 16-17).



*ing Co.*, 143 F. 2d 412, rendered since the decision in the instant case, is directly in point and in accord with the decision below. To the same effect are *Monarch Theatres, Inc. v. Helvering*, 137 F. 2d 588 (C. C. A. 2d); *Phebus Oil Co. v. Commissioner*, 134 F. 2d 217 (C. C. A. 5th); and *Little John Coal Co. v. Smith*, 135 F. 2d 666, 667 (C. C. A. 7th).

*Automotive Parts Co. v. Commissioner*, 134 F. 2d 420 (C. C. A. 6th) (Pet. 9, 23) does not conflict with the holding in this case. There the only issue was whether, on the one hand, an exchange of writings was sufficiently definite to constitute a written and enforceable contract, or whether, on the other hand, it amounted merely to preliminary negotiation. Whether contract or negotiation, the correspondence there was between the corporation as such and the creditor; and not as here, only between stockholders of a parent corporation. Thus, the issue in this case was not before the court in the cited case and was not there decided (see R. 107). The decision of the Eighth Circuit Court of Appeals in *Harding Glass Co. v. Commissioner*, 142 F. 2d 41, is also not in conflict, for there the principal issue was one of construction of the terms of a contract concededly made by the taxpayer corporation; here, on the other hand, the question is whether taxpayer ever made a contract at all.

## CONCLUSION

For the reasons above given, it is respectfully submitted that the petition for a writ of certiorari should be denied.

CHARLES FAHY,

*Solicitor General.*

SAMUEL O. CLARK, Jr.,

*Assistant Attorney General.*

J. LOUIS MONARCH,

I. HENRY KUTZ,

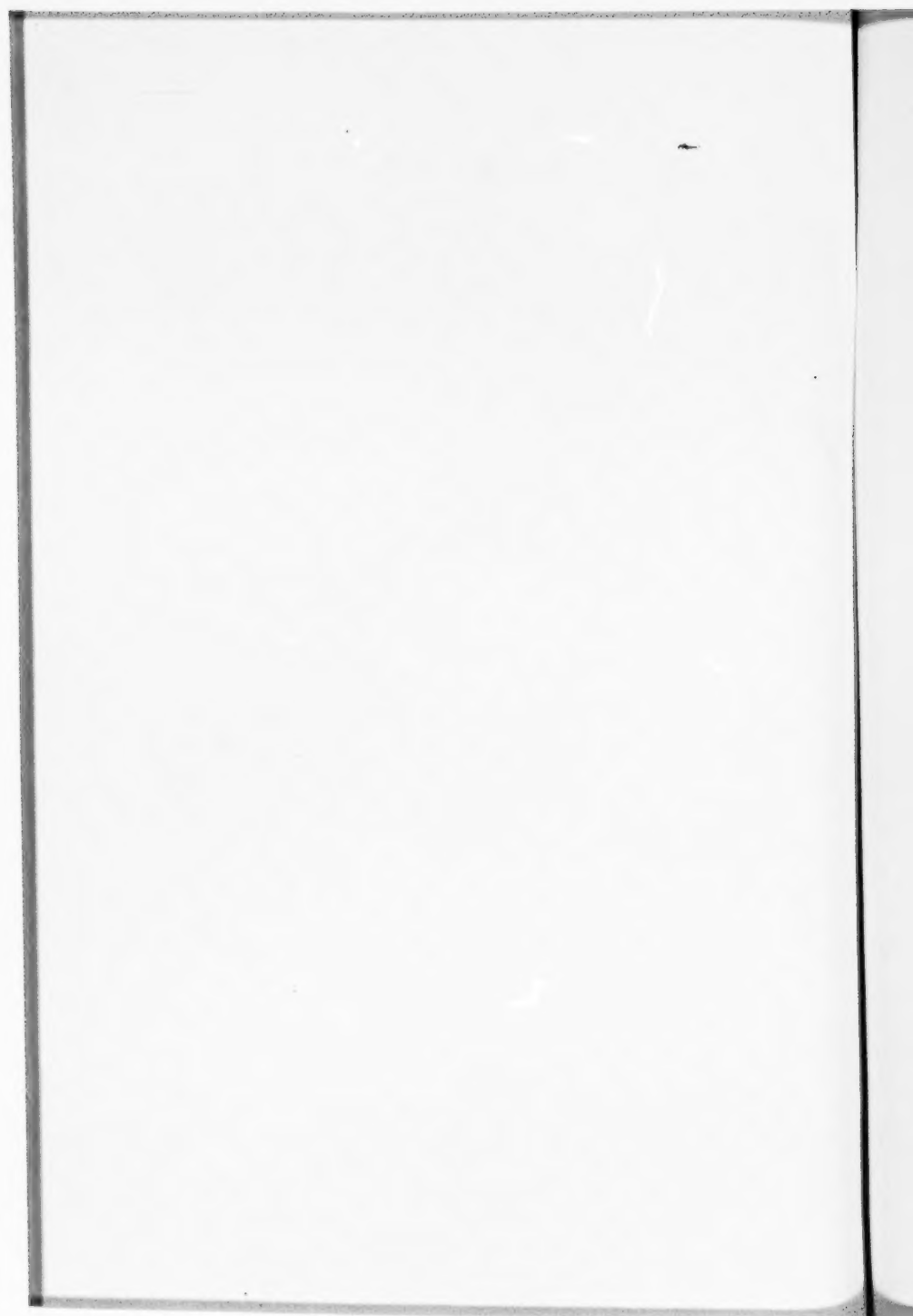
*Special Assistants to the Attorney General.*

WALTER J. CUMMINGS, Jr.,

*Attorney.*

SEPTEMBER 1944.





## APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

### SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—

(1) The term “adjusted net income” means the net income minus the sum of—

(A) The normal tax imposed by section 13.

(B) The credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

(C) In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933), the amount allowed as a credit under section 26 (d).

(D) In the case of a national mortgage association created under Title III of the National Housing Act, the amount allowed as a credit under section 26 (e).

(2) The term “undistributed net income” means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

17 per centum of the portion of the undistributed net income which is in excess of 20 per centum and not in excess of 40 per centum of the adjusted net income.

22 per centum of the portion of the undistributed net income which is in excess of 40 per centum and not in excess of 60 per centum of the adjusted net income.

27 per centum of the portion of the undistributed net income which is in excess of 60 per centum of the adjusted net income.

\* \* \* \*

#### SEC. 26. CREDITS OF CORPORATION.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

\* \* \* \*

##### (c) *Contracts Restricting Payment of Dividends.*—

(1) *Prohibition on Payment of Dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more cred-

its are equal in amount only one shall be taken into account.

(2) *Disposition of Profits of Taxable Year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

(3) *Double Credit Not Allowed.*—If both paragraph (1) and paragraph (2) apply, the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

Revenue Act of 1942, c. 619, 56 Stat. 798:

SEC. 501. ADDITIONAL CREDITS FOR UNDISTRIBUTED PROFITS TAX.

(a) *Amendments to the Revenue Act of 1936.*—

(1) Section 14 (a) (2) of the Revenue Act of 1936 (relating to definition of undistributed net income) is amended to read as follows:

"(2) The terms 'undistributed net income' means the adjusted net income minus the sum of (A) the dividend paid credit provided in section 27, (B) the credit provided in section 26 (c) relating to restrictions on payment of dividends, (C) except in cases where section 26 (c) (1) is applicable, the deficit credit provided in section 26 (f), and (D) the redemption credit provided in section 26 (g)."

(2) Section 26 (c) of the Revenue Act of 1936 (relating to credits of corporations) is amended by amending the heading to read as follows: "(c) *Restrictions on Payment of Dividends.*—"; and by amending paragraph (3) to read as follows:

"(3) *Deficit Corporations.*—In the case of a corporation having a deficit in accumulated earnings and profits as of the close of the preceding taxable year, the amount of such deficit, if the corporation is prohibited by a provision of a law or of an order of a public regulatory body from paying dividends during the existence of a deficit in accumulated earnings and profits, and if such provision was in effect prior to May 1, 1936.

"(4) *Double Credit Not Allowed.*—If more than one of the credits provided in the foregoing paragraphs (1), (2), and (3) apply, then the paragraph which allows the greatest credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied."

(3) Section 26 of the Revenue Act of 1936 (relating to credits of corporations) is amended by adding at the end thereof the following new subsections:



“(f) *Deficit Credit*.—The amount by which the adjusted net income exceeds the sum of (1) the earnings and profits accumulated after February 28, 1913, as of the beginning of the taxable year, and (2) the earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year). For the purposes of this subsection, earnings and profits of the taxable year shall be computed without diminution by the amount of the tax imposed under section 14, 102, 103, or 351 for such taxable year; and earnings and profits accumulated after February 28, 1913, as of the beginning of the taxable year, shall be diminished on account of the tax under section 14, 102, 103, or 351 for any previous taxable year only by the amount of such tax as computed under the amendments made by section 501 of the Revenue Act of 1942.

“(g) *Stock Redemption Credit*.—An amount equal to the portion of the recognized gain, realized within the taxable year and prior to March 3, 1936, from the sale or other disposition of a capital asset, which, pursuant to a contract, was distributed prior to such date to shareholders in redemption in whole or in part of preferred stock and which is not otherwise allowable as a credit under any other provision of this section or section 27.”

(b) *Effective Date of Amendments*.—The amendments made by subsection (a) shall be effective as of the date of the enactment of the Revenue Act of 1936.

\* \* \* \* \*

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

Art. 14-1. [As amended by T. D. 5263, 1943 Cum. Bull. 1003] **SURTAX ON UNDIS-  
TRIBUTED PROFITS OF CORPORATIONS.**—In gen-  
eral, the Act imposes a surtax on the net  
income of corporations in an amount  
measured by the undistributed net income.  
The rates of surtax are graduated in  
brackets, the lowest rate being 7 percent  
of that portion of the undistributed net  
income not in excess of 10 percent of the  
adjusted net income and the highest rate  
being 27 percent of that portion of the  
undistributed net income which is in excess  
of 60 percent of the adjusted net income.

The adjusted net income is defined in  
section 14 (a) (1) as the net income (see  
section 21) minus the sum of (1) the nor-  
mal tax imposed by section 13 and (2) the  
credit provided in section 26 (a), relating  
to interest on certain obligations of the  
United States and its instrumental-  
ities. \* \* \*

The undistributed net income is defined  
in section 14 (a) (2) as the adjusted net in-  
come minus the sum of (a) the dividends  
paid credit provided in section 27 (see  
articles 27 (a)-1 to 27 (h)-1, inclusive), (b)  
the credit provided in section 26 (c), re-  
lating to restrictions on payment of divi-  
dends (see article 26-2 (c)), except where  
section 26 (c) (1) is applicable, the deficit  
credit provided in section 26 (f) (see  
article 26-4), and (d) the redemption credit  
provided in section 26 (g) (see article  
26-5).

Art. 26-2. [As amended by T. D. 5263,  
*supra*] **CREDIT IN CONNECTION WITH RESTRIC-  
TIONS ON PAYMENTS OF DIVIDENDS.**—

(a) The credit provided in section 26 (c)  
with respect to the restriction on the pay-

ment of dividends is not available under every contractual or statutory prohibition which might operate to restrict the payment of dividends, but only with respect to those provisions of a written contract, a law, or an order of a public regulatory body, as the case may be, which satisfies the conditions prescribed in the Act. The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of section 26 (c). The restrictive provisions recognized by the Act are of three general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payments of dividends during the taxable year;

(2) Those which come within section 26 (c) (2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings and profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936; and

(3) Those which come within section 26 (c) (3), in that they prohibit the distribution of dividends during the existence of a preexisting deficit in earnings and profits.

If a corporation is restricted with respect to the payment of dividends by two or more contract provisions coming within section 26 (c) (1), only the largest of the credits computed with respect to each of such provisions, and not their sum, shall be allowable under section 26 (c) (1) and, for such purpose, if two or more credits are equal in amount, only one shall be taken into account. However, section 26 (c) (4) provides that if more than one of the credits

provided in section 26 (c) (1), section 26 (c) (2), and section 26 (c) (3) apply, then the paragraph which allows the greatest credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

(b) *Prohibition on payment of dividends.*—The credit provided in section 26 (c) (1) is allowable only with respect to a written contract executed by the corporation prior to May 1, 1936, which expressly deals with the payment of dividends and operates as a legal restriction upon the corporation as to the amounts which it can distribute within the taxable year as dividends. If an amount can be distributed within the taxable year as a dividend—

(1) in one form (as, for example, in stock or bonds of the corporation) without violating the provisions of a contract, but can not be distributed within the taxable year as a dividend in another form (as, for example, in cash) without violating such provisions, or

(2) at one time (as, for example, during the last half of the taxable year) without violating the provisions of a contract, but can not be distributed as a dividend at another time within the taxable year (as, for example, during the first half of the taxable year) without violating such provision—

then the amount is one which, under section 26 (c) (1), can be distributed within the taxable year as a dividend without violating such provisions.

The credit provided in section 26 (c) (1) is equal to the excess of the adjusted net income, as defined in section 14 (a), over

the aggregate of the amounts which can be distributed within the taxable year without violating the provisions of such contract. The requirement that the provisions of the contract expressly deal with the payment of dividends is not met in case (1) a corporation is merely required to set aside periodically a sum to retire its bonds, or (2) the contract merely provides that while its bonds are outstanding the current assets shall not be reduced below a specified amount. \* \* \*

(c) *Disposition of profits of taxable year.*—Under the provisions of section 26 (c) (2), a corporation is allowed a credit in an amount equal to that portion of the earnings and profits of the taxable year which, by the terms of a written contract executed by the corporation prior to May 1, 1936, and expressly dealing with the disposition of the earnings and profits of the taxable year, it is required within the taxable year to pay in, or irrevocably to set aside for, the discharge of a debt incurred on or before April 30, 1936. The credit is limited to that amount which is actually so paid or irrevocably set aside during the taxable year pursuant to the requirements of such a contract.

Only a contractual provision which expressly deals with the disposition of the earnings and profits of the taxable year shall be recognized as a basis for the credit provided in section (c) (2). A corporation having outstanding bonds is not entitled to a credit under a provision merely requiring it, for example, (1) to retire annually a certain percentage or amount of such bonds, (2) to maintain a sinking fund sufficient to retire all or a certain percent-

age of such bonds by maturity, (3) to pay into a sinking fund for the retirement of such bonds a specified amount per thousand feet of timber cut or per ton of coal mined, or (4) to pay into a sinking fund for the retirement of such bonds an amount equal to a certain percentage of gross sales or gross income. Such provisions do not expressly deal with the disposition of earnings and profits of the taxable year. A contractual provision, however, shall not be considered as not expressly dealing with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of "net income," "net earnings," or "net profits."

The term "debt" as used in section 26 (c) (2) does not include an obligation of the corporation to a shareholder, as such, as distinguished from a creditor. Accordingly, amounts paid into, or set aside for, a sinking fund by a corporation for the retirement of preferred stock, pursuant to the terms of an agreement underlying the preferred stock issue, shall not be considered as set aside for discharge of a debt. An indebtedness evidenced by bonds or other similar obligations issued by a corporation is incurred as of the date such obligations are issued, and the amount of such indebtedness is the amount represented by the face value of the obligations. For the purpose of this article a bond or other similar obligation is not issued until it is executed and delivered to a person who holds it as a debt of the corporation. Bonds issued after April 30, 1936, in exchange in refunding a preexisting issue represents debts incurred after April 30, 1936, within the meaning of section 26 (c) (2).

\* \* \* \* \*

ART. 26-4. DEFICIT CREDIT. [As added by T. D. 5263, *supra*].—Section 26 (f) is designed to be used particularly in those cases where the surtax on undistributed profits can not be avoided because the corporation has adjusted net income but has no accumulated earnings and profits at the beginning of the year and no earnings and profits of the taxable year on account of certain unallowable deductions, such as capital losses. In such a case a credit is allowed in the amount by which the adjusted net income exceeds the sum of the earnings and profits, if any, accumulated after February 28, 1913 (as of the beginning of the taxable year), and those of the taxable year, computed as of the close of such year, without regard to distributions made during the year, or to the amount of the surtax on undistributed profits imposed under section 14, the graduated income tax or surtax imposed under section 102, the tax on citizens and corporations of certain foreign countries imposed under section 103, or the surtax on personal holding companies imposed under section 351, for the taxable year. In computing earnings and profits as of the beginning of the taxable year accumulated after February 28, 1913, the taxes just mentioned for any previous taxable year are to be deducted only as computed under the amendments provided by section 501 of the Revenue Act of 1942. If there is a deficit in the accumulated earnings and profits as of the beginning of the taxable year, or for the taxable year, such deficit shall not be taken into consideration in determining the credit allowable under section 26 (f), and in such a case the earnings and profits as of the beginning of the taxable year, or the



earnings and profits of the taxable year, shall be considered as zero.

The application of the provisions of section 26 (f) may be illustrated by the following examples:

Example (1). The M Corporation on the accrual basis for the calendar year 1936 had a gross income of \$300,000, miscellaneous deductions of \$106,000, capital losses of \$92,000 of which only \$2,000 were deductible due to the provisions of section 117 (d), and a normal tax liability under section 13 of \$28,840. Its adjusted net income was therefore \$171,160 (\$300,000 less \$106,000 less \$2,000 less \$28,840) while its earnings and profits of the taxable year computed after deducting the normal tax imposed by section 13 for such year but without diminution by the amount of the tax imposed for such year by section 14, 102, 103, or 351, were \$73,160 (\$300,000 less \$106,000 less \$92,000 less \$28,840). Assuming that the corporation had no accumulated earnings and profits as of December 31, 1935, it is allowed, in computing its undistributed net income subject to tax under section 14, a credit under section 26 (f) of \$98,000, the amount by which the adjusted net income of \$171,160 exceeds the earnings and profits of the taxable year.

Example (2). If in the above example there was a contract in existence prior to May 1, 1936, under which the M Corporation could not distribute dividends in excess of \$150,000 during the calendar year 1936, section 26 (c) (1) is applicable and allows a credit of \$98,000, namely, an amount equal to the excess of the adjusted net income, \$171,160, over the aggregate of the amounts which can be distributed



within the taxable year as dividends, \$73,160. Accordingly, the credit allowance under section 26 (f) is inapplicable.

Example (3). Assume in example (1) that the M Corporation had a deficit of \$20,000 in accumulated earnings and profits as of December 31, 1935, and that the State law prohibited dividend distributions during the existence of a deficit in accumulated earnings and profits. In addition to the deficit credit of \$98,000 provided in section 26 (f), the M Corporation, under paragraph (3) of section 26 (c) is allowed a credit of \$20,000, the amount of the deficit in accumulated earnings and profits as of December 31, 1935.